



LEASE LIABILITY IN A SALE AND LEASEBACK – PROPOSED AMENDMENTS TO IFRS 16

Issued 29 March 2021

ICAEW welcomes the opportunity to comment on the *Lease Liability in a Sale and Leaseback - proposed amendments to IFRS 16* published by the IASB in November 2020, a copy of which is available from this [link](#).

We agree that clarity is needed in this area as IFRS 16 *Leases* currently includes only limited guidance on accounting for sale and leaseback transactions involving variable lease payments not dependent on an index or rate. We are, however, concerned that the proposals are conceptually flawed and will be challenging to understand and apply in practice. We recommend that the Board looks again at its proposals and considers whether there may be a more appropriate way forward.

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KEY POINTS

CLARITY IS NEEDED

1. ICAEW agrees that clarity is needed in this area as IFRS 16 *Leases* currently includes only limited guidance on accounting for sale and leaseback transactions involving variable lease payments not dependent on an index or rate. In particular, there is no guidance on how right-of-use assets and lease liabilities arising from such transactions should be measured initially, or on the subsequent accounting for lease liabilities, when the lease payments are variable but not based on an index or rate. We agree that additional guidance is needed to reduce the risk of inconsistent application. We are, however, concerned that the proposals are conceptually flawed and will be challenging to understand and apply in practice.

POSSIBLE SOLUTIONS

2. In this letter we have considered the benefits and disadvantages of the exposure draft's proposals, along with two possible alternative solutions to the conundrum of how to account for sale and leaseback transactions, namely:
 - Excluding variable lease payments, other than those contingent on an index or rate or that are 'in-substance' fixed payments, when calculating the lease liability. This would result in recognising the 'full' gain on sale if, for example, the payments are entirely based on future sales or usage.
 - Deferring the gain on the proportion of the asset retained and subsequently amortising it to profit or loss over the term of the lease.
3. We recommend that the Board looks again at its proposals and consider whether there may be a more appropriate way forward.

TRANSITION

4. We do not believe that the Board should pursue the proposals in the exposure draft. What transition guidance will be appropriate will depend on the solution the Board ultimately decides to implement.
5. If the Board decides to implement the proposals in the exposure draft, we have the following comments on the proposed transition guidance:
 - The proposed transition guidance requires retrospective application except when estimating variable lease payments retrospectively is possible only with the use of hindsight. It will, however, often be difficult to estimate variable lease payments retrospectively without applying hindsight. It will also be challenging to determine whether hindsight is in fact being applied.
 - We therefore think it would be better if a prospective approach whereby the seller-lessee determines the expected lease payments at the beginning of the annual period in which the amendment is first applied was the required approach.
 - An exception allowing retrospective application could be permitted where the seller-lessee made an explicit estimate of variable payments at the date of the transaction ie, they can clearly show that hindsight is not being applied.

ILLUSTRATIVE EXAMPLES

6. The illustrative examples included in the draft amendment are very helpful, making it much easier to understand the requirements and their impact in practice. A further example covering a situation in which the lease terms are off market would be beneficial.

POST IMPLEMENTATION REVIEW OF IFRS 16

7. We believe that variable lease payments should be considered more widely as part of the IFRS 16 post implementation review rather than creating an exception for sale and leaseback transactions.

ANSWERS TO SPECIFIC QUESTIONS

Question 1 – Measurement of the right-of-use asset and lease liability arising in a sale and leaseback transaction (paragraphs 100(a)(i), 100A and 102B of the [Draft] amendment to IFRS 16)

The [Draft] amendment to IFRS 16 Leases applies to sale and leaseback transactions in which, applying paragraph 99 of IFRS 16, the transfer of the asset satisfies the requirements to be accounted for as a sale of the asset.

The [Draft] amendment proposes:

- (a) to require a seller-lessee to determine the initial measurement of the right-of-use asset by comparing the present value of the expected lease payments, discounted using the rate specified in paragraph 26 of IFRS 16, to the fair value of the asset sold (paragraph 100(a)(i));**
- (b) to specify the payments that comprise the expected lease payments for sale and leaseback transactions (paragraph 100A); and**
- (c) to specify how a seller-lessee subsequently measures the lease liability arising in a sale and leaseback transaction (paragraph 102B).**

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

8. ICAEW agrees that clarity is needed in this area as IFRS 16 currently includes only limited guidance on accounting for sale and leaseback transactions involving variable lease payments not dependent on an index or rate. In particular, there is no guidance on how right-of-use assets and lease liabilities arising from such transactions should be measured initially, or on the subsequent accounting for lease liabilities, when the lease payments are variable but not based on an index or rate. We agree that additional guidance is needed to reduce the risk of inconsistent application. We are, however, concerned that the proposals are conceptually flawed and will be challenging to understand and apply in practice.

The proposals are conceptually flawed

9. The treatment of variable lease payments was extensively debated when the Board was developing IFRS 16. We consistently argued that lease payments should only be included in the measurement of assets and liabilities arising from a lease where they represent unavoidable obligations for the lessee. The Board ultimately agreed with us on this, allowing only rentals that are contingent on an index or rate, or that are ‘in-substance’ fixed payments, to be included in the lease liability.
10. These proposals provide an exception to this rule, by requiring entities entering into sale and leaseback agreements to include all expected variable lease payments when calculating the lease liability. We appreciate that the Board’s aim is to better reflect the economics of the transaction by ensuring that the gain or loss recognised on sale is limited to the proportion of the asset sold. But the proposed amendments result in a liability being recognised which includes payments that some would argue the lessee is currently under no obligation to pay. The proposals could also have profit and loss effects that are difficult to understand.
11. We do acknowledge that on initial recognition the liability represents a meaningful economic phenomenon in that it equals the present value of the expected future payments. However,

on subsequent measurement this is no longer the case until or unless the lease is modified or a reassessment event occurs. While management may be confident in its estimates at the outset, things may change over time meaning actual payments made in later years could be significantly different to what was initially expected. This would result in the recognised liability bearing little relation to the expected future cash flows in subsequent periods.

12. Moreover, having two completely different approaches to such payments is a very unsatisfactory solution. It creates comparability problems as leases with variable lease payments entered into as part of a sale and leaseback agreements will be measured differently to similar leases entered into in other circumstances.
13. We believe that variable lease payments should be considered more widely as part of the IFRS 16 post implementation review rather than creating an exception for sale and leaseback transactions.

The proposals may be difficult to apply in practice

14. There are also potential problems when it comes to applying the proposals in practice:
 - It may be difficult to accurately estimate how much will be payable under the lease, particularly for agreements with long lease terms. Estimating variable lease payments adds extra complexity and judgement, resulting in a high level of measurement uncertainty.
 - Tracking the difference between estimated and actual payments could also be problematic and time-consuming in practice.
 - Updating estimates of expected variable payments in the event of a lease modification could also be potentially challenging.
 - Existing systems may not cope with having this exception to the normal treatment of variable lease payments.
15. If the Board decide to continue with these proposals, we urge them to provide additional guidance on how estimates of variable lease payments should be made and, where necessary, revised.

Other possible solutions

16. There are two other solutions that we believe the Board should consider.
 - Excluding variable lease payments, other than those contingent on an index or rate or that are 'in-substance' fixed payments, when calculating the lease liability. This would result in recognising the 'full' gain on sale if, for example, the payments are entirely based on future sales or usage.
 - Deferring the gain on the proportion of the asset retained and subsequently amortising it to profit or loss over the term of the lease.
17. We consider these options in more detail below.

Recognising the 'full' gain upfront

18. This approach would ensure consistency between how leases with variable lease payments are measured, regardless of whether they are entered into as part of a sale and leaseback agreement. It would, however, result in the 'full' gain on sale being recognised in some cases rather than limiting the day one gain to the proportion of the asset sold.
19. We appreciate that the Board are reluctant to adopt this approach and we share some of their concerns. We do, however, have some sympathy for some of the arguments set out in Françoise Flores's alternative view and agree that a case can be made for full derecognition

of the asset sold and recognition of any related gain in full as there has been a significant change in the seller-lessee's economic circumstances.

Deferring the gain on the proportion of the asset retained

20. Another alternative would be to develop a simplified approach that results in deferring the gain on the proportion of the asset retained and recognising a right-of-use asset as a proportion of the pre-sale carrying value on the same basis. The deferred gain would then be amortised to profit or loss over the term of the lease but would not be remeasured in other circumstances. This approach would avoid some of the complexities and conceptual inconsistencies in the proposed approach and would be somewhat consistent with the accounting treatment historically applied for sale and finance leasebacks under IAS 17.
21. This approach would avoid the conflict with IFRS 16's more general requirements relating to variable lease payments as the deferred gain would be distinguished from lease liabilities.
22. If such an approach were to be pursued then guidance would be needed on how to determine the proportion of the gain to be deferred and asset value to be (de-)recognised. The proposals in the exposure draft could be used for this purpose ie, comparing the fair value of the asset sold to the present value of the total expected payments – including variable payments.
23. This approach could however be simplified further by permitting alternative methods of estimating the proportion of the asset to be (de-)recognised and hence the deferred gain. While we believe the approach in the exposure draft is certainly acceptable, it can be complex and result in a high level of measurement uncertainty. We believe that there could be other equally valid ways of determining the proportion of the asset retained. For example, in many cases comparing the lease term to the asset's useful life could provide an appropriate – and relatively straightforward – basis for calculation.
24. This approach would also overcome a number of the practical concerns outlined in paragraph 14 above.
25. If the Board were to adopt this approach, additional guidance would be needed on how the deferred gain is classified on the balance sheet and what disclosures would be needed. For example, guidance would be needed on whether or not such a liability is a financial liability that is within the scope of IFRS 9, how the amortisation should be presented in profit or loss and whether the amortisation period would be revised on a change of lease term.

There is no perfect solution

26. Each of the options, including the one proposed by the Board, has its own imperfections.
27. The Board's proposals would create an exception to the general approach to variable lease payments but – as discussed above – we believe this solution is conceptually flawed and comes with a number of practical problems. The Board, however, argue that creating such an exception is necessary as it better reflects the economics of the transaction.
28. Recognising the 'full' gain upfront is also troublesome. In her alternative view, Ms Flores makes a case for doing so as she believes there has been a significant change in the seller-lessee's economic circumstances which merits full derecognition of the asset. However, some may argue that a sale and leaseback is only a partial sale in substance and may therefore be more persuaded by the Board's arguments in BC9 of the exposure draft.
29. There are also issues with deferring a proportion of the gain and subsequently amortising it to profit or loss over the term of the lease. Some will argue that it involves the recognition of a liability that is hard to justify under the *Conceptual Framework*. The economic relevance of the subsequent amortisation credits to profit or loss are also open to challenge.

30. We recommend that the Board looks again at its proposals and consider whether either of the solutions discussed above – or any other alternative solutions – may be a more appropriate way forward.

Other comments

31. The structure of the proposed amendments and frequent use of cross referencing makes the proposed guidance unnecessarily convoluted and hard to follow. We would prefer the new guidance to be more clearly drafted and self-contained.
32. There appears to be a conflict between paragraph 100(a)(ii) of the proposed amendments and paragraph BC11. The former says that ‘the seller-lessee shall initially measure the lease liability at the present value of the expected lease payments’ while the latter says that ‘the lease liability... is then derived from how the right-of-use asset is measured’. The former appears to be correct as it is consistent with the examples included in the exposure draft.
33. The illustrative examples included in the draft amendment are very helpful, making it much easier to understand the requirements and their impact in practice. A further example covering a situation in which the lease terms are off market would be beneficial.

Question 2 – Transition (paragraph C20E of the [Draft] amendment to IFRS 16)

Paragraph C20E of the [Draft] amendment to IFRS 16 proposes that a seller-lessee apply the [Draft] amendment to IFRS 16 retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors to sale and leaseback transactions entered into after the date of initial application of IFRS 16. However, if retrospective application to a sale and leaseback transaction that includes variable lease payments is possible only with the use of hindsight, the seller-lessee would determine the expected lease payments for that transaction at the beginning of the annual reporting period in which it first applies the amendment.

Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you suggest instead and why.

34. As discussed above, we do not believe that the Board should pursue the proposals in the exposure draft. What transition guidance will be appropriate will depend on the solution the Board ultimately decides to implement.
35. If the Board decides to implement the proposals in the exposure draft, we have the following comments on the proposed transition guidance:
- The proposed transition guidance requires retrospective application except when estimating variable lease payments retrospectively is possible only with the use of hindsight. It will, however, often be difficult to estimate variable lease payments retrospectively without applying hindsight. It will also be challenging to determine whether hindsight is in fact being applied.
 - We therefore think it would be better if a prospective approach whereby the seller-lessee determines the expected lease payments at the beginning of the annual period in which the amendment is first applied was the required approach.
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